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In the Supreme Court of the United States

OCTOBER TERM, 1988

FIRST INTERSTATE CREDIT ALLIANCE, INC.
Petitioner

v.

AMERICAN BANK OF MARTIN COUNTY,
DOUGLASS E. WENDEL
Respondents

PETITION FOR A WRIT OF CERTIORARI
TO THE
UNITED STATES COURT OF APPEALS
FOR THE
ELEVENTH CIRCUIT

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QUESTION PRESENTED

Does a beneficiary who draws on a standby letter of credit receive a preference in bankruptcy under 11 U.S.C. §547 (*b*) solely because the issuer required the debtor to provide security?

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FIRST INTERSTATE CREDIT ALLIANCE, INC.
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v.

AMERICAN BANK OF MARTIN COUNTY,
DOUGLASS E. WENDEL
Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

First Interstate Credit Alliance, Inc.[1] petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

In re Air Conditioning, Inc. of Stuart, 845 F.2d 293 (11th Cir. 1988) (App. A1).

In re Air Conditioning, Inc. of Stuart, 72 B.R. 657 (S.D. Fla. 1987) (App. A10).

In re Air Conditioning, Inc. of Stuart, 55 B.R. 157 (Bankr. S.D. Fla. 1985) (App. A18).

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[1] Petitioner First Interstate Credit Alliance, Inc. is a wholly-owned subsidiary of First Insterstate Bancorp. Petitioner was formerly known as Leasing Service Corporation and is referred to as such in all the opinions below and throughout this petition.

JURISDICTION

The judgment of the court of appeals was entered May 17, 1988 (App. A1). A petition for rehearing was denied on June 20, 1988 (App. A9). The jurisdiction of this court is invoked pursuant to 28 U.S.C. §2101(c).

STATUTE INVOLVED

11 U.S.C. §547(*b*) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property–
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made–
>
> (A) on or within 90 days before the date of the filing of the petition;
>
> * * *
>
> (5) that enables such creditor to receive more than such creditor would receive if–
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

STATEMENT

In December, 1982, Petitioner, Leasing Service Corporation ("LSC"), leased a computer system to Air Conditioning, Inc. of Stuart ("ACI"). To secure ACI's performance under the lease, ACI granted LSC a security interest in all of ACI's assets. ACI defaulted under the lease in February, 1984. In April of that year, LSC filed suit in Florida state court seeking to replevy the computer system and ACI's other assets. After LSC recovered the computer system, the court ordered the issuance of a writ of replevin to seize the remainder of ACI's assets.

In consideration of LSC's agreement to refrain from seizing ACI's remaining property, ACI agreed to establish a letter of credit to guarantee

payment if the pending litigation was ultimately resolved adversely to ACI. On June 14, 1984, ACI paid Respondent, American Bank of Martin County ("American Bank"), a fee of $2,904.35 to issue a standby letter of credit naming LSC beneficiary. To memorialize ACI's obligation to repay American Bank if LSC drew upon the letter of credit, ACI executed a promissory note in the sum of $20,030.15 payable to the bank. Six days later at American Bank's insistence, ACI delivered a $20,000.00 certificate of deposit to American Bank to secure payment under the promissory note.[2]

Approximately six weeks later, on July 25, 1984, ACI filed a petition for reorganization under Chapter 11 of the United States Bankruptcy Code. LSC subsequently attempted to draw on the letter of credit. American Bank refused to honor the letter of credit and filed a complaint in the bankruptcy court alleging that LSC was violating the automatic stay. The trustee, Respondent Douglass E. Wendel, intervened. The bankruptcy court, without a trial, found that LSC had received a voidable preference, nullified the letter of credit, and ordered American Bank to surrender the certificate of deposit to the trustee. The district court reversed the bankruptcy court's nullification of the letter of credit, but affirmed the finding that LSC had received a preference.

On appeal, the court of appeals affirmed, finding that LSC had obtained a preference voidable by the bankruptcy trustee. Examining the provisions of 11 U.S.C. §547(*b*), the court reasoned that ACI's pledge of the certificate of deposit to American Bank as security for ACI's promissory note was an "indirect transfer" of ACI's assets "for the benefit of" LSC. Concluding that a preference had occurred, the court held that the beneficiary of the letter of credit, LSC, was the recipient of the preferential transfer. Both the district court and the court of appeals professed the independence of the letter of credit but nevertheless held that the entire letter of credit transaction resulted in a preference because the debtor gave security to the issuer. The act of furnishing security at American Bank's insistence resulted in a preference, thus transfering the risk of insolvency from the issuer to the beneficiary, LSC.

The court of appeals relied heavily on a recent decision of the Fifth Circuit. *See In re Compton Corp.*, 831 F.2d 586 (5th Cir. 1987) (App. A21).[3] The *Compton* court exhaustively examined several non-letter of

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[2] LSC has no connection whatsover with American Bank and had no involvement in procuring the letter of credit which was established pursuant to negotiation between counsel for ACI and LSC. Despite the bankruptcy court's conclusion that LSC was "grossly undersecured," ACI apparently believed that its assets were worth at least $20,000.

[3] Judge Brown of the Fifth Circuit sat on the panels of both *Compton* and the case *sub judice*.

credit cases where unsecured creditors improved their positions through circuitous transfers of the debtor's assets. In each of those cases, the courts examined the overall impact of the multiple transfers and reached the conclusion that voidable preferences had occured. The *Compton* court then applied this reasoning to letter of credit transactions where the beneficiary was an unsecured creditor owed an antecedent debt. Claiming that its ruling preserved the sanctity of letters of credit while carrying out the purposes of the Bankruptcy Code, the court concluded that the trustee could recover from the beneficiary of the letter of credit because the beneficiary had "received an indirect preference."

Without examining the independence rule or the fundamental purpose of letters of credit, the *Compton* court went to great lengths to explain why the issuing bank had not received a preference in bankruptcy. That court reasoned that the bank had given "new value" by issuing the letter of credit and had perfected its security interest outside the preference period by virtue of a future advances clause in an earlier security agreement. The court also concluded that the transfer of the debtor's assets was not for the benefit of the bank, even though it was the bank which required that the repayment obligation be secured with the debtor's property. The court stated that:

> [T]he issuer of the letter of credit, being just the intermediary through which the preferential transfer was accomplished, completely falls out of the picture and is not involved in this particular legal proceding. *Id.* at 594.

REASONS FOR GRANTING THE PETITION

With more than 120 billion dollars of standby letters of credit currently outstanding,[4] the court of appeals has undermined the ability of letters of credit to perform their most basic and critical economic function: the absolute guaranty of payment. The court's holding that payment under a letter of credit may constitute a preference to the beneficiary disregards both the commercial expectations of the parties and defeats the fundamental purpose of letters of credit: the absolute guaranty of payment. The court of appeals' decision ignores several basic tenets of letter of credit law which are critical to the continued economic utility and efficacy of letters of credit. The crux of this petition is the adverse

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[4]Petition for Certiorari at 7, *Federal Deposit Insurance Corp. v. Philadelphia Gear Corp.*, 106 S.Ct. 1931 (1986) (No. 84-1972). The value of standby letters of credit by the United States' 100 largest banks increased to approximately $134 billion by 1984. Kozolchyk, *Is Present Letter of Credit Law Up To Its Task?*, 8 Geo. Mason U. L. Rev. 286, 304 n. 38 (1986). *See* Note, *The Independence Rule in Standby Letters of Credit*, 52, U. Chi. L. Rev. 218, 219 n. 14 (1985) (by 1978 five banks alone had $12.6 billion worth of outstanding standby letters of credit).

economic effect of the court of appeals' decision on the use of standby letters of credit as absolute guaranties of prompt payment. Immediate review by this court of the question presented is appropriate.

The ancient law governing letter of credit transactions is premised on the independent nature of each of the three discrete undertakings which are common to all letter of credit transactions: the obligations between

a. the debtor and the creditor;
b. the debtor and its bank (the "issuer"); and
c. the issuer and the creditor (the "beneficiary").[5]

The obligations of the parties to any one of these undertakings is completely separate and independent of the other two undertakings which together constitute a single letter of credit transaction. This principle is known as the "independence rule." This rule is the key to the commercial vitality of the letter of credit.[6]

Under the court of appeals' rationale, LSC has received a voidable preference solely because the issuer, American Bank, required ACI to secure its repayment obligation. Had American Bank not required security from ACI, no preference would have occurred. According to the reasoning of the court below, ACI's pledge of the certificate of deposit at the issuer's request is the operative fact which created the preference as to LSC. *Air Conditioning*, 845 F.2d at 296 (App. A3). Whether a beneficiary of a letter of credit receives a preferential transfer is, therefore, completely beyond the beneficiary's power or control. The court of appeals conferred that power on the issuing bank yet imposed the risk of preference on the beneficiary. This inequitable allocation is contrary not only to the law governing letters of credit, but also to fundamental notions of fairness and commercial expectation.

The primary issue then becomes which party to a letter of credit transaction properly bears the preference risk, if any. The court of appeals has granted the issuer of a letter of credit the unfettered discretion to place the beneficiary at risk. The issuer may, without risk to itself, seek additional security placing the beneficiary in jeopardy.

Courts, including the *Compton* court, have recognized that in a letter of credit transaction, the issuing bank is the best suited to evaluate

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[5] *In re Guy C. Long, Inc.*, 74 B.R. 939, 943 (Bankr. E.D. Pa. 1987); B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶8.2[1] (rev. ed. 1981).

[6] *See* McLaughlin, *Letters of Credit as Preferential Transfers in Bankruptcy*, 50 Fordham L. Rev. 1033, 1039-1040 (1982); Note, *The Independence Rule in Standby Letters of Credit*, 52 U. Chi. L. Rev. 218 (1985). *See, also, United States v. Sun Bank of Miami*, 609 F.2d 832 (5th Cir. 1980); *Pringle-Associated Mortgage Corp. v. Southern National Bank*, 571 F.2d 871 (5th Cir. 1978). The independence rule is codified in U.C.C. §5-114(1).

its customer's risk of insolvency:[7]

> Under a standby letter of credit, the bank becomes primarily liable to the beneficiary upon the default of the bank's customer to pay for goods or services. The bank charges a fee to issue a letter of credit and to undertake this liability. The shifting of liability to the bank rather than to the services or goods provider is the main purpose of a letter of credit. After all, *the bank is in a much better position to assess the risk of its customer's insolvency* than is the service or goods provider (emphasis added). *Compton*, 831 F.2d at 590.[8]

The issuing bank should not be permitted to utilize its "better position" to unilaterally impose a greater risk on the unsuspecting beneficiary. The decisions of *Compton* and the court below give a bank the power not only to determine the risk of insolvency but also, after charging a fee for assuming the risk, shift this risk to another, the unwary beneficiary.

An issuing bank pays a letter of credit from its own funds.[9] Accordingly, the court of appeals acknowledged that the *proceeds* from a letter of credit *are not property of the debtor's estate.*[10] The court also recognized that the undertaking between the issuing bank and the beneficiary is independent of the transaction between the bank and its customer. Yet, from these legal declarations, the court traced the certificate of deposit from the debtor to the bank and then, in effect, traced the proceeds from the certificate of deposit to the bank's funds which ultimately are paid LSC under the letter of credit. This type of tracing is exactly what the independence rule prohibits. The finding of an "indirect transfer" vitiates the essential purpose of the independence rule.

Proceeds from a letter of credit are either part of the debtor's estate or they are not. The court of appeals in one breath states that the proceeds are not part of the debtor's estate but in the next permits the trustee to recover the proceeds from LSC for *inclusion* in the debtor's estate. This type of illogical reasoning takes all meaning from the words themselves; in essence, the court of appeals has made the proceeds of a letter of credit property of the debtor's estate. By its own

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[7] *See In re Page*, 18 B.R. 713 (D.D.C. 1982); *In re North Shore & Central Illinois Freight Co.*, 30 B.R. 377 (Bankr. N.D. Ill. 1983).

[8] The *Compton* court then distinguished the "risk of the debtor's insolvency" from "risk of a preference attack". LSC submits that this is an artificial and improper distinction.

[9] *In re Clothes, Inc.*, 35 B.R. 487 (Bankr. D.N.D. 1983).

[10] *Air Conditioning*, 845 F.2d at 296; *In re Marine Distributors, Inc.*, 522 F.2d 791 (9th Cir. 1975) (the first decision to examine the relationship between letters of credit and bankruptcy).

terms, 11 U.S.C. §547(*b*) applies only to a "transfer of an interest of the debtor in property."

Prior to *Compton* and the case *sub judice*, only one exception existed for defeating the independence rule: fraud.[11] Any concern that letters of credit could be used to intentionally avoid the preference provisions of the code are unfounded. The rules governing fraud in letter of credit transactions prevent that result.

If a creditor were to persuade a debtor to obtain a letter of credit in the creditor's favor with the intent of avoiding the preference provisions of the code and perpetrate a fraud on the bankruptcy court or the debtor's other creditors, that court could properly enjoin the creditor from drawing on the letter of credit. This remedy is consistent with well-established letter of credit principles dealing with fraud. The integrity of the Bankruptcy Code and letters of credit would *both* be preserved without venturing beyond the parameters of accepted precedent.[12] "In short, the letter of credit is an irrevocable obligation of the bank which the debtor is powerless to affect except pursuant to the traditional defenses of fraud."[13] The court's reasoning defeats this basic premise.

The court of appeals erred in holding that LSC receives a voidable preference when it draws on the letter of credit from American Bank. The court misperceived the nature of letters of credit, and failed to consider adequately the commercial expectations of the business world and the repercussions of a finding that a letter of credit may constitute a preference as to the beneficiary in the absence of fraud. Under the court of appeals' ruling, a letter of credit is no longer an absolute guaranty of payment. The wall surrounding the sanctity and independence of letters of credit has been ruptured by the court, even though it states otherwise.

Commenting on the district court's assertion that it was preserving the sanctity of letters of credit, Professor Clark stated that:

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[11] Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. Chi. L. Rev. 130, 144-145 (1982); Note, *The Independence Rule in Standby Letters of Credit*, 52 U. Chi. L. Rev. 218, 219 (1985). The fraud exception was first applied in the seminal case of *Sztejn v. Henry Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). (The *Sztejn* rule is codified in U.C.C. §5-114(2)(6)).The fraud issue has recently been extensively litigated in cases involving post-revolutionary Iran. *See, e.g., Harris Corp. v. National Iranian Radio & Television*, 691 F.2d 1344 (11th Cir. 1982); *KMW Int'l v. Chase Manhattan Bank, N.A.*, 606 F.2d 10 (2d Cir. 1979); *American Bell Int'l v. Islamic Republic of Iran*, 474 F.Supp. 420 (S.D.N.Y. 1979).

[12] In the present case, neither American Bank nor the trustee even hint that LSC's agreement with ACI was fraudulent.

[13] Chaitman, *infra* n. 14 at 33.

> The difficulty with the [district] court's approach is that it elevates form over substance. By treating the letter and the reimbursement agreement as a single composite transaction for preference purposes, the opinion requires the beneficiary to pay back the proceeds of the draw. How does this result maintain the "sanctity" of the letter of credit? A beneficiary cares little whether it bears the loss by "nullification" or by forced regurgitation under Section 550 (a) of the Bankruptcy Code. In either case, the issuing bank comes out even and the estate retains the value of the property pledged to secure the bank's reimbursement claim. Although the [district] court paid lip service to the "independence principle" of letter of credit law, it violated that principle by treating the letter and the bank's right of reimbursement as part of a two-step composite transaction for preference purposes. B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶8.11 [2] (cum. supp. 1988).

This criticism is equally applicable to the court of appeals decision affirming the district court.

Air Conditioning and *Compton* are not the only recent assaults on the inviolability of letters of credit. The business and banking community has only recently recovered from the impact of another Florida bankruptcy decision: *In re Twist Cap, Inc.*.[14] In *Twist Cap*, the bankruptcy court first articulated the theory that a beneficiary could receive an impermissible preference if a beneficiary were permitted to draw on a letter of credit. This conclusion created what one commentator characterized as "a tempest in the world of commercial finance."[15]

Prior to *Twist Cap*, letter of credit-backed debt was rated solely on the basis of the creditworthiness of the issuing bank. This method of rating letter of credit-backed debt is valuable because a borrower is able to obtain a credit rating based upon the creditworthiness of its bank rather than its own. Reliance on the stronger credit of the bank permits a borrower to secure a lower interest rate for financing.[16] As a result of the *Twist Cap* preference threat to letters of credit, however, Standard & Poor's could no longer rely on such readily and ascertainable indicia, stating that "absent the resolutions of the 'Twist Cap'

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[14] 1 B.R. 284 (Bankr. M.D. Fla. 1979).

[15] Chaitman & Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap*, 38 Bus. Law. 21, 22 (1982).

[16] Clark, *supra* n.4 at ¶8.11[1] (cum. supp. 1988); Baron, *Debt Supported by Irrevocable Letters of Credit, Irrevocable Commitments and Note Purchase Agreements*, Fixed Income Investor 553 (June 21, 1980).

problem. . . S & P will not rate [letter of credit-backed debt] solely on the creditworthiness of the bank."[17]

Courts, commentators and legislators alike have universally criticized *Twist Cap*.[18] Professor Kozolchyk observed that:

> [T]he *Twist Cap* court's approach can lead to. . . a finding of voidability, as a preference. . . These rules have already created serious national disruption and could also have detrimental international implications. They reflect a basic misunderstanding of standby and commercial letter of credit transactions, law and practice.[19]

Senator Dennis DeConcini, one of the primary drafters and sponsors of the Bankruptcy Code, stated in the United States Senate that:

> Contrary to language in the case of *Twist Cap*. . . payments . . . by the letter of credit bank are *not* preferential. . . since payments are not being made with property of the estate. 126 Cong. Rec. 31,153 (1980).

The consistent and vehement rejection of *Twist Cap* prompted Standard & Poor's to announce in March 1987 that *Twist Cap* had become sufficiently remote to be no longer a concern in letter of credit transactions.

When the furor over *Twist Cap* subsided, letters of credit were once again widely believed to be safe from preference attack. Predictably, the successful preference attack in *Air Conditioning* and *Compton* has prompted a swift response from the business community. Standard & Poor's again refuses to rate letter of credit-backed debt unless certain additional conditions are met.[20] This increases the cost of obtaining letters of credit and adversely affects their ability to serve as an absolute guaranty of payment. *Twist Cap* disrupted letter of credit transactions for nearly eight years despite a maelstrom of criticism. Two decisions of the courts of appeals, however, will undoubtedly have a more lasting impact on letters of credit.

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[17] Baron, *LOCs and the "Twist Cap" Problem*, Standard & Poor's CreditWeek (Jan. 25, 1982).

[18] *See, e.g., In re Page*, 18 B.R. 713 (D.D.C. 1982); *In re Guy C. Long, Inc.*, 74 B.R. 939, 944 (Bankr. E.D. Pa. 1987) (exhaustive summary of cases dealing with letters of credit in bankruptcy); Hahn & Schwartz, *Letters of Credit under the Bankruptcy Code*, 16 U.C.C.L.J. 91 (1983); Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. Chi. Rev. 130 (1982); Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guaranties*, 24 Ariz. L. Rev. 319, 343 (1982); Chaitman & Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap*, 38 Bus. Law. 21 (1982).

[19] Kozolchyk, *supra* n. 18 at 343.

[20] Federman & Baron, *Bankruptcy Cases Impact LOCs*, Standard & Poors CreditWeek (Feb. 1, 1988).

Other legal bases exist for questioning the propriety of the court of appeals' conclusion. Standby letters of credit are occasionally referred to as "guaranty letters of credit," more accurately descriptive of their function.[21] The beneficiary of a letter of credit can easily be analogized to the beneficiary of a guaranty. A beneficiary of a guaranty does not receive a preference in bankruptcy when paid by the guarantor even though the primary obligor is bankrupt.[22] No preference is created because the payment depletes the assets of the guarantor *not* the debtor. Due to the functional similarities between letters of credit and guaranties, beneficiaries of letters of credit should receive no worse treatment than beneficiaries of a simple guaranty; the unique and necessarily inviolable nature of letters of credit dictate this result. The payment to the beneficiary of a letter of credit should not be recaptured by the debtor or trustee as a preference.

CONCLUSION

The decision of the court of appeals *sub judice* as well as that of *Compton* unnecessarily deviate from well-established letter of credit and bankruptcy preference principles even though an adequate remedy already existed. Financial markets which only recently recovered from the effects of *Twist Cap* are again disrupted.[23] The petition for certiorari should be granted so that this Court may more fully review the adverse impact of the court's decision on letters of credit.

Respectfully submitted,

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September 16, 1988

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[21] Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guaranties*, 24 Ariz. L. Rev. 319 (1982).

[22] *Atlantic Richfield Co. v. Good Hope Refineries, Inc.*, 604 F.2d 865 (5th Cir. 1979); *In re Zaferis Bros. & Co., Ltd.*, 67 F.2d 140 (9th Cir. 1933); *First National Bank of Danville v. Phalen*, 62 F.2d 21 (7th Cir. 1932). *Accord National Bank of Newport v. National Herkimer County Bank*, 225 U.S. 178 (1912).

[23] Because of the impact of the court of appeals decision on letters of credit and commercial finance, we believe that review by this court is warranted despite the absence of an existing conflict in the circuits on the precise question presented.

In re AIR CONDITIONING, INC. OF STUART, Debtor.

AMERICAN BANK OF MARTIN COUNTY, Douglass E. Wendel, Trustee, Plaintiffs-Appellees,

v.

LEASING SERVICE CORPORATION, Defendant-Appellant.

No. 87-5223.

United States Court of Appeals, Eleventh Circuit.

May 17, 1988.

Before VANCE and ANDERSON, Circuit Judges, and BROWN*, Senior Circuit Judge.

VANCE, Circuit Judge:

This bankruptcy appeal involves an undersecured creditor's attempt to obtain the proceeds of a $20,000 certificate of deposit used to secure a letter of credit issued in favor of the creditor. Both the bankruptcy court and the district court held that there had been a preference, and the district court ordered the creditor to deliver the payment made pursuant to the letter of credit to the trustee. Except as to an award of attorneys' fees, we affirm.

I.

In December 1982 Leasing Service Corporation (LSC) leased a computer system to Air Conditioning, Incorporated of Stuart (ACI). To secure its performance under the lease, ACI granted LSC a security interest in everything ACI owned.[1] ACI defaulted in February 1984, and in April LSC instituted replevin actions against ACI in Florida state court.

During June the parties negotiated a solution to the problem so that ACI could remain in business. They reached an agreement whereby LSC agreed not to exercise its right to seize ACI's property. On June 11 ACI agreed in a joint stipulation to furnish a $20,000 bond within four days. If it failed to furnish the bond, LSC would seize all of ACI's assets

* Honorable John R. Brown, Senior U.S. Circuit Judge for the Fifth Circuit, sitting by designation.

[1] A supplemental writ of replevin LSC later obtained pursuant to this security interest ordered ACI to deliver to LSC: "All goods, chattels, fixtures, furniture, equipment, assets and property of any kind whatever located now and hereafter belonging to Air Conditioning, Inc. of Stuart and in which Air Conditioning, Inc. of Stuart has any interest."

as provided in the supplemental writ of replevin LSC had previously obtained. In either event, the agreement provided that LSC would replevin the computer equipment. On June 19, the parties agreed to a new joint stipulation which stated that ACI's obligation to furnish the bond had been met by the terms and provisions of a June 15, 1984 letter of credit issued by American Bank in LSC's favor. In return for the letter of credit ACI had executed a promissory note payable to American Bank in the amount of $20,030.15. ACI had secured the note with a security interest in a $20,000 certificate of deposit.

As a result of these transactions, LSC allowed ACI to stay open for business. ACI's reprieve, however, only lasted a month. On July 25, 1984 ACI filed a petition under Chapter 11. On September 14 the bankruptcy court granted LSC's motion for relief from the stay to allow LSC to obtain a judgment for possession and judicial sale of the computer equipment. On October 4 the bankruptcy court lifted the automatic stay further to permit LSC to proceed against ACI's other assets as described in the supplemental writ of replevin. LSC claims it never located any assets of ACI other than the computer system. In November 1984 the case was converted to a Chapter 7 liquidation proceeding.

On May 23, 1985 LSC demanded that American Bank honor the letter of credit. American Bank responded by filing a complaint in the bankruptcy court, alleging that LSC was violating the automatic stay. The trustee filed an intervention complaint. The bankruptcy court, without a trial, nullified the letter of credit, ordered American Bank to surrender the certificate of deposit to the trustee, and awarded American Bank attorneys' fees and costs associated with the original complaint.[2] The district court reversed the bankruptcy court's nullification of the letter of credit, but affirmed the bankruptcy court's finding of a preference in favor of LSC. 72 B.R. 657. The district court ruled that the trustee could attack the preference under 11 U.S.C. § 550(a). LSC now appeals the district court's order.

II.

A.

LSC's primary argument on appeal is that the district court and the bankruptcy court erred by ruling that the trustee had proved all five

[2]American Bank had filed an interpleader action previously in Florida state court. This action apparently was dismissed voluntarily because an interpleader action is improper in letter of credit situations like this one. *See Dallas Bank & Trust Co. v. Community Dev. Corp.*, 686 S.W.2d 226, 230-31 (Tex.Ct.App.1985). American Bank recovered the fees and expenses associated with this aborted state court interpleader action. We reverse this award.

elements of a preferential transfer under 11 U.S.C. § 547(b). That subsection allows the trustee to avoid any transfer of property of the debtor:

> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made –
>
> (A) on or within 90 days before the date of the filing of the petition;
>
> . . . . . .
>
> (5) that enables such creditor to receive more than such creditor would receive if –
>
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b). The trustee may recover any property transferred in violation of section 547(b) from "the initial transferee of such transfer or the entity for whose benefit such transfer was made. . ." *Id.* § 550(a)(1). LSC argues that the trustee failed to prove elements (1) and (5) under section 547(b), and that the district court erroneously granted relief under section 550(a).

Initially LSC argues that there has been no preferential transfer because the letter of credit issued by American Bank is not "an interest of the debtor in property," as required by the first sentence of section 547(b). Waving a banner acclaiming the inviolability of letters of credit, LSC argues that section 547(b) cannot apply in this case.

We agree with LSC that neither a letter of credit nor its proceeds are property of the debtor's estate. *See In re AOV Indus., Inc.*, 64 B.R. 933, 941 (Bankr.D.D.C.1986); *In re Clothes, Inc.*, 35 B.R. 487, 489 (Bankr.D.N.D.1983). As the district court correctly noted, a letter of credit is an undertaking between the issuing bank and the beneficiary, and is independent of the relationship between the bank and the account party. *In re Air Conditioning, Inc. of Stuart*, 72 B.R. 657, 660 (S.D.Fla.1987); *see Pro-Fab, Inc. v. Vipa, Inc*, 772 F.2d 847, 852-53 (11th Cir.1985).

Collateral which has been pledged by the debtor as security for a letter of credit, however, is property of the debtor's estate. *In re Compton Corp.*, 831 F.2d 586,590 (5th Cir.1987). It was the transfer of the $20,000 by the debtor ACI to American Bank as collateral for the letter of credit that constituted the preferential transfer under section 547(b). As the Fifth Circuit recently held: "When a debtor pledges its assets to

secure a letter of credit, a transfer of debtor's property has occurred under the provisions of 11 U.S.C. § 547." *Compton*, 831 F.2d at 590. Thus there was a transfer of ACI's property, and section 547(b) applies in this case.

Turning to the disputed elements of section 547(b), LSC contends first that the transfer of the $20,000 was not "to or for the benefit" of LSC. *See* 11 U.S.C. § 547(b)(1). Instead, LSC maintains that the transfer of the $20,000 to purchase the certificate of deposit was solely and exclusively for the benefit of the bank.

The Fifth Circuit's recent *Compton* opinion contains an excellent, scholarly discussion of this issue. It held that a creditor can receive an indirect benefit in the letter of credit context sufficient to meet the requirement of section 547(b)(1). *See* 831 F.2d at 591-95. We agree that an indirect transfer arising from a debtor's pledge of security to a third party bank "may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party." *Id.* at 591-92. The district court in this case correctly held that "although the transfer of the certificate of deposit (the debtor's property) was made to American Bank it was clearly 'for the benefit' of LSC because it indirectly secured payment of an undersecured antecedent debt owed by ACI." 72 B.R. at 661. In addition the promised transfer of the certificate of deposit induced American Bank to issue the letter of credit in the first place. We hold therefore that LSC did receive a benefit under section 547(b)(1).[3]

LSC contends next that the transfer did not enable LSC to receive more than it would have received in a Chapter 7 liquidation had the transfer not been made. *See* 11 U.S.C. § 547(b)(5). LSC argues that the trustee failed to present any evidence that ACI's assets were insufficient to satisfy fully LSC's claims. LSC complains that the bankruptcy court did not allow LSC the opportunity to show that ACI may have had assets in which LSC had a valid security interest.

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[3]The Fifth Circuit eloquently and forcefully articulated this principle in *Compton:*

> We hold that a creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction. The purpose of the letter of credit transaction in this case was to secure payment of an unsecured antecedent debt for the benefit of an unsecured creditor. This is the only proper way to look at such letters of credit in the bankruptcy context. The promised transfer of pledged collateral induced the bank to issue the letter of credit in favor of the creditor. The increased security interest held by the bank clearly benefitted the creditor because the bank would not have issued the letter of credit without this security. A secured creditor was substituted for an unsecured creditor to the detriment of the other unsecured creditors.

831 F.2d at 594-95.

The trustee responds that the bankruptcy court determined that section 547(b)(5) was satisfied on the basis of the bankruptcy schedules which showed LSC was grossly undersecured.[4] The trustee correctly points out that he asked the bankruptcy court to take judicial notice of the schedules, and that LSC did not object.[5] In its memorandum decision, the bankruptcy court stated that "the essential facts appear from undisputed documents or are otherwise admitted...." LSC again made no motion or objection to this statement in the bankruptcy court. LSC did not protest the bankruptcy court's reliance on the schedules until LSC was before the district court on appeal, where LSC complained in its brief that although the bankruptcy court "did take judicial notice of the Bankruptcy schedules... that is not evidence nor is it binding on LSC." This protest, however, was too late, and because LSC failed to object to the schedules at the trial level in the bankruptcy court, the schedules are indeed binding on LSC. *Cf. In re Shults*, 28 B.R. 395, 396 (Bankr. 9th Cir. 1983) (debtors impliedly consented to trial of creditor's claims for relief as presented through failure to object).

On the basis of these schedules, the bankruptcy court found that because the unsecured claims on the debtor's estate could not be satisfied in full, the transfer at issue gave LSC more than it would have received in a Chapter 7 liquidation without the transfer. The trustee therefore met his burden under section 547(b)(5).

LSC makes much of the fact that there was no hearing in the bankruptcy court. LSC argues that it is impossible to determine whether the certificate of deposit was purchased with the debtor's own funds, and now asks this court to remand the case for a hearing on the origin of the $20,000.

When a third party makes a loan to a debtor which enables the debtor to satisfy a creditor's claim, the proceeds of the loan do not become part of the debtor's estate. *See In re Price Chopper Supermarkets, Inc.*, 40 B.R. 816, 820 (Bankr.S.D.Cal.1984); *In re Castillo*, 39 B.R. 45, 46 (Bankr.D.Colo.1984); *In re Sun Railings, Inc.*, 5 B.R. 538, 539 (Bankr.S.D.Fla.1980). There are several possible sources from which

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[4]The bankruptcy court found that ACI's total debts exceeded its assets by at least $50,000. ACI's personal property, valued by ACI at $21,711, was subject to liens of $173,470. The trustee had sold all of ACI's tangible personal property for $1,000. The court concluded that LSC was "grossly undersecured."

[5]The transcript of the October 24, 1985 hearing reads:

The Court: You would ask me to take judicial notice of the schedules?

[Counsel for the Trustee]: Yes, your Honor.

The Court: The schedules will tell me what the debts are.

Counsel for LSC responded to this exchange by renewing his argument that a letter of credit cannot be property of the debtor's estate. At no time did LSC object to the introduction or use of the bankruptcy schedules.

the $20,000 could have come such that the transfer to the bank would not have created a preference. Once again, LSC did not initiate an inquiry into this possibly important issue.

In its brief to the district court, LSC argued that "[n]o discovery ever took place on that issue as the Bankruptcy Judge deemed it to be irrelevant." This is not, however, an accurate account of what occurred in the bankruptcy court. At the October 24, 1985 hearing, LSC raised the issue of the source of the funds used to purchase the certificate of deposit. The bankruptcy judge responded:

> I will . . . allow you, for the purposes of protecting your record, to pursue discovery on that point, and I will require any person that you want answers from to give you answers that would give the entire genesis and the history of that money within reason, if that is your wish . . .

Thus the bankruptcy court practically *encouraged* LSC to pursue discovery on this issue. LSC simply failed to follow up.[6]

LSC raises some potentially meritorious contentions with respect to the source of the $20,000. LSC did not pursue these avenues, however, in the bankruptcy court. Although we will consider an issue not raised below if it involves a pure question of law and if refusal to consider it would result in a miscarriage of justice, *Roofing & Sheet Metal Servs., Inc. v. La Quinta Motor Inns, Inc.*, 689 F.2d 982, 990 (11th Cir.1982), the issue in this case of the source of the $20,000 is a pure question of fact. Bankruptcy cases are to be tried in bankruptcy court. We therefore affirm the district court and the bankruptcy court and hold that the trustee proved all elements of a preferential transfer under 11 U.S.C. § 547(b).

B.

Despite the existence of a transfer which satisfies the five elements of section 547(b), the trustee may not avoid a transfer as a preference if the transfer was "intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor . . . ." *Id.* at § 547(c)(1)(A).[7] LSC argues that its acceptance of the letter of credit and its release of its right to seize ACI's inventory and property pursuant to the supplemental

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[6]LSC similarly argued to the district court that it had never waived its right to present evidence. This is true. It is also true, however, and more determinative of this appeal, that LSC did not pursue the opportunities it had to discover and present evidence.

[7]The Bankruptcy Code defines "new value" as money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation. 11 U.S.C. § 547(a)(2).

writ of replevin constitute "new value" under section 547(c)(1)(A).

This argument overlooks the fact that whatever value LSC created by these actions was not new. As in *Compton*, the bank in this case issued the letter of credit "to secure an antecedent unsecured debt due the beneficiary of the letter of credit. The unsecured creditor beneficiary gave no new value upon the issuance of the letter of credit." *Compton*, 831 F.2d at 594. An agreement by an undersecured creditor to forego its right to foreclose on collateral cannot be treated as a new value under section 547. *Drabkin v. A.I. Credit Corp.*, 800 F.2d 1158, 1159 (D.C. Cir.1986). Forbearance from exercising pre-existing rights does not consititute new value under section 547(a)(2). *See Charisma Inv. Co., N.V. v. Air Florida Sys., Inc.*, 68 B.R. 596, 600-03 (S.D.Fla. 1986); *Matter of Lario*, 36 B.R. 582, 584 (Bankr.S.D.Ohio 1983); *cf. Matter of Duffy*, 3 B.R. 263, 266 (Bankr.S.D.N.Y.1980) (forbearance by lessor from repossession of rented vehicle did not enhance the value of debtor's estate and therefore did not constitute new value within § 547(c)(1) as defined by § 547(a)(2)). The letter of credit transaction therefore did not give ACI new value, and LSC cannot use section 547(c)(1) as a defense to the trustee's avoidance of the preferential transfer under section 547(b).

C.

Finally LSC argues that the district court erred by allowing the trustee to recover the proceeds of the letter of credit from LSC pursuant to 11 U.S.C. § 550(a)(1) because the trustee sought relief from the bank and not LSC. LSC complains that the trustee's complaint failed to give LSC notice of the nature of the claim against it, and the remedy requested, thus depriving LSC of procedural due process.

LSC doth protest too much. Although the parties' initial pleadings were perhaps misguided, *see supra* note 2, it has been clear from the outset what this dispute is about: The $20,000 certificate of deposit.The district court, in fact, did not allow the trustee to recover the proceeds of the letter of credit (as LSC characterizes the district court's judgment). Instead, the district court correctly allowed the trustee to recover from LSC the property transferred: the certificate of deposit. The Bankruptcy Code explicitly provides for this by allowing the trustee to recover a preferential transfer from "the initial transferee of such transfer *or the entity for whose benefit such transfer was made* . . . ." 11 U.S.C. § 550(a)(1) (emphasis added). The district court did this primarily to uphold the sanctity of letters of credit as vital instruments of commerce, the virtues of which LSC so vigorously extols. The record thoroughly presented the preference issue, and the district court did not abuse its discretion in resolving it. *See In re Pizza of Hawaii, Inc.*, 761 F.2d 1374, 1380 (9th Cir.1985); *cf. In re Espino*, 806 F.2d 1001, 1002

(11th Cir.1986) (where the record reflects an issue was presented in a cursory manner and never properly presented to the bankruptcy court, the issue is not preserved for appeal).[8] We therefore affirm the district court's ruling that the trustee can recover the transfer under section 550(a).

III.

The district court's order affirming the bankruptcy court's award of attorneys' fees associated with American Bank's initial interpleader action is REVERSED. In all other repsects, the district court's judgment is AFFIRMED.

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[8]LSC attempts to distinguish *Pizza of Hawaii* on the grounds that the bankruptcy court denied LSC the opportunity to develop a complete factual record on the preference issue. The bankruptcy court, however, did not deny LSC this opportunity. *See supra* Part II.A.

IN THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

No. 87-5223

FILED
U.S. COURT OF APPEALS
ELEVENTH CIRCUIT
JUN 20 1988
MIGUEL J. CORTEZ
CLERK

IN RE:

AIR CONDITIONING, INC. OF STUART,

Debtor,

AMERICAN BANK OF MARTIN COUNTY,
DOUGLASS W. WENDEL, trustee,

Plaintiffs-Appellees,

versus

LEASING SERVICE CORPORATION,

Defendant-Appellant.

Appeal from the United State District Court for the Southern District of Florida

ON PETITION(S) FOR REHEARING

(June 20, 1988)

BEFORE: VANCE and ANDERSON, Circuit Judges, and BROWN*, Senior Circuit Judge.

PER CURIAM:

The petition (s) for rehearing filed by appellant, LEASING SERVICE CORPORTATION, is Denied.

ENTERED FOR THE COURT:

/s/ Robert S. Vance
United States Circuit Judge

*Honorable John R. Brown, Senior U.S. Circuit Judge for the Fifth Circuit, sitting by designation.

In re AIR CONDITIONING, INC. OF STUART, Debtor.

LEASING SERVICE, CORPORATION, Appellant,

v.

Douglas E. WENDEL, as trustee for Air Conditioning, Inc. of Stuart, and American Bank of Martin County, Appellees.

Bankruptcy Nos. 86-8006-CIV-NES-BITT, 84-01395-BKC-TCB and 85-0965-BKC-TCB-A.

United States District Court, S.D. Florida.

May 10, 1987.

CORRECTED MEMORANDUM OPINION AND ORDER

NESBITT, District Judge.

I. NATURE OF THE APPEAL

This is an appeal from a memorandum decision and judgment by the United States Bankruptcy Court entered in an adversary proceeding involving a pre-bankruptcy transaction by the debtor. The Bankruptcy Court nullified the debtor's promissory note, an assignment of its certificate of deposit and a Bank's letter of credit and ordered return of the certificate of deposit to the bankrupt's estate. Upon review of the decision and judgment of the Bankruptcy Court the Bankruptcy Court's "[f]indings of fact should not be set aside unless clearly erroneous." Bankruptcy Rule 8013, *In re All American of Ashburn, Inc.*, 805 F.2d 1515 (11th Cir.1986); *Matter of Hammons*, 614 F.2d 399 (5th Cir.1980). However, the conclusions of law made by the Bankruptcy Court are subject to *de novo* review by this Court. *In Re All American, supra; Hammons, supra.* For the reasons hereinafter given upon a *de novo* review, the Bankruptcy Court's conclusion of law by which it "nullified" a letter of credit is contrary to controlling principles of law and shall be reversed. In all other respects the opinion and judgment appealed from is affirmed.

II. PROCEDURAL HISTORY

On or about April 24, 1984 Leasing Service Corporation (LSC) obtained a writ of replevin directed toward the recovery of computer equipment which was leased by it to Air Conditioning, Inc. of Stuart, (ACI). LSC sought the writ as a result of ACI's failure to make payments on account of debt admittedly owing and past due under the lease of

the computer equipment owned by LSC. A supplemental writ of replevin was issued on May 9, 1984 to recover all of ACI's "goods and assets" in which LSC had a security interest pursuant to the term of the lease. Apparently to avoid being put out of business completely, ACI arranged for a $20,000 letter of credit to be issued on June 15, 1984 by AMERICAN BANK OF MARTIN COUNTY (AMERICAN BANK) for the account and benefit of LSC in return for LSC's promise not to enforce the second writ of replevin. As consideration for AMERICAN BANK's issuance of the letter of credit ACI executed an unsecured promissory note dated June 15, 1984 and payable to AMERICAN BANK, which was to be secured by a $20,000 certificate of deposit owned by the debtor ACI[1] The assignment and delivery of the certificate of deposit took place some six days later, on or about June 21, 1984.

On July 25, 1984, just over one month later, ACI filed a voluntary petition in bankruptcy under Chapter 11. Thereafter LSC sought and obtained relief from the automatic stay to liquidate the computer system previously replevied by it from ACI. The liquidation of the computer equipment was not sufficient to discharge the amount due and owing LSC. On November 8, 1984 the Chapter 11 case was converted to a Chapter 7 liquidation proceeding and Douglass E. Wendel was appointed as trustee (Trustee). On May 10, 1985 LSC obtained a state court judgment in the amount of $40,447 against ACI.

Thereafter, on or about May 23, 1985, LSC made a timely demand upon AMERICAN BANK to honor its letter of credit. Instead of honoring the draft, AMERICAN BANK filed an adversary proceeding against LSC in the Bankruptcy Court seeking *inter alia* a judgment determining the validity of any lien or interest by LSC in the letter of credit. The trustee filed an intervention complaint seeking the return of the certificate of deposit on the theory that its transfer constituted a voidable preference under 11 U.S.C. § 547(b). LSC took the position that there had been no transfer of property to or for the benefit of a creditor, an essential element of a preference under 11 U.S.C. § 547(b)(1). After some threshold issues being raised as to whether the Bankruptcy Court should dismiss or decline to exercise jurisdiction, the Bankruptcy Judge conducted two hearings and after considering stipulated facts and memorandums of law entered the decision and judgment appealed from.

The creditor LSC urges several procedural and substantive grounds for reversal or for remand with instructions to enter judgment for LSC and against the AMERICAN BANK in accordance with the terms of

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[1]The promissory note provided that the $20,000 certificate of deposit was to be deposited with the bank no later than fifteen (15) days from the date of the note.

the letter of credit. LSC claims error by the Bankruptcy Judge's "enjoining" the drafting of the letter of credit and cites a legion of legal authority for the proposition that it is "improper" for a Bankruptcy Court to enjoin the drafting upon a letter of credit on the theory that preference has occurred or may occur by reason of the honoring of the letter of credit. *In re Clothes, Inc.*, 35 B.R. 489 (Bankr.D.N.D.1983), *In re Price Chopper Supermarkets Inc.*, 40 B.R. 816 (Bankr.S.D. Calif.1984). However, the Bankruptcy Court did not "enjoin" the letter of credit, but agreed with AMERICAN BANK's position that the letter of credit should be canceled and the bank released from its obligations thereunder. The net effect, however, was to nullify the letter of credit which could threaten the disruption of commerce and banking as they are dependent upon the traditional integrity of the letter of credit.

The trustee, having prevailed, urges affirmance of the Bankruptcy Court ruling as being "well within the jurisdiction of the Bankruptcy Court" to set aside a preferential transfer under § 547 of the Bankruptcy Code.

The New York Clearing House Association (the "Clearing House") has filed an *amicus curiae* brief before this Court. The Clearing House urges that the Bankruptcy Court decision nullifying the letter of credit is contrary to well established legal precedent and "threatens to create uncertainty and confusion which would undermine the function of letters of credit generally as an essential element of commerce."

III. LEGAL DISCUSSION

The primary issue which governs disposition of this appeal is whether under the stipulated facts of this case the Bankruptcy Court exceeded its authority when it nullified the letter of credit. This, in turn, depends on whether the letter of credit transaction was a transfer of property of the debtor (ACI) for the benefit of the creditor (LSC) so as to be considered a preferential transfer under 11 U.S.C. § 547(b).

In order to put this case in perspective an important fact should be kept in mind. The debt owed by ACI to LSC existed prior to the issuance of the letter of credit. In other words, there is no question that the debt owed by ACI was an "antecedent" debt. Thus, if ACI had given LSC an additional security interest of any kind to secure repayment of the debt, rather than providing for the issuance of the letter of credit, the transfer clearly would have been subject to being avoided as a preference by the trustee under 11 U.S.C. § 547(b)[2] The question

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[2] 11 U.S.C. § 547(b) provides that "the trustee may avoid any transfer of an interest of the debtor in property . . . (2) for or on account of an antecedent debt owed by the debtor before such transfer was made."

that then arises is whether a debtor should be able, through the recognized sanctity of a letter of credit, to secure payment of an antecedent debt when he could not do so through any other type of security interest.

One can understand how in the interest of efficiency, and looking to substance rather than form, the Bankruptcy Court found that the letter of credit was part of a "single contemporaneous transaction"(i.e., the promissory note, the letter of credit and the assignment of collateral) which transferred property of the bankrupt debtor. Additionally, the transfer of the certificate of deposit depleted the estate of the bankrupt debtor ACI and conferred a benefit on the creditor LSC to the detriment of other creditors which is the essence of a preferential transfer.

However, there is an equally compelling factor to be considered in that a letter of credit is traditionally an instrument of commerce that travels with no baggage except that which is acquired by its terms. The independence of the letter of credit is well established. It is a fundamental principle of commercial transactions that a letter of credit is an undertaking solely of the issuing bank to the beneficiary; it is independent of the obligations of the issuing bank and the account party. *See* Fla.Stat. § 675.109. *Pringle-Associated Mortgage Corp. v. Southern National Bank*, 571 F.2d 871 (5th Cir.1978); *Pro-Fab, Inc. v. Vipa Inc.*, 772 F.2d 847 (11th Cir.1985). Thus under the facts of this case, an apparent conflict exists between the preference provisions of the Bankruptcy Code and established principles governing the uniqueness of a letter of credit.

Putting aside the propriety of the Bankruptcy Court "nullifying a letter of credit" as a remedy, it is necessary first to determine whether the composite transaction completed between ACI and the AMERICAN BANK during the six day period between June 15, and June 21, 1984 constituted a "preference." The creditor LSC conceded three of the five elements of a preference as specified in 11 U.S.C. § 547, contesting only elements (1) and (5). The pertinent parts of § 547(b) are as follows:

> "...the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor...(and)
>
> (5) that enables such creditor to receive more than such creditor would receive (in Chapter 7 liquidation proceedings)."

Once a preference is established under § 547(b) the trustee may recover, if the Court so orders, the "value of such property, from...the initial transferee of such transfer or the entity for whose benefit such transfer was made..." § 550(a)(1).

a. *Transfer of Property of the Debtor to or for Benefit of a Creditor*

LSC takes the position that there was no transfer of property by ACI for the benefit of LSC because the only transfer of the debtor's property occurred six days after the issuance of the letter of credit when ACI delivered the $20,000 certificate of deposit to AMERICAN BANK. It follows therefore, according to LSC, that at the time the letter of credit was issued for the benefit of LSC, there was no transfer of the debtor's property for LSC's benefit, and that since LSC was not a party to the transaction between AMERICAN BANK and ACI, it did not receive a preference by receiving the letter of credit. LSC further reasons that at the time the certificate of deposit was pledged it was for the benefit of the Bank and became the Bank's collateral, not LSC's, and therefore the issuance of the letter of credit was not a transfer of property of the debtor's estate for the benefit of a creditor. LSC concludes that if anyone, it was AMERICAN BANK that received a preferential transfer because it transformed an unsecured obligation of ACI into a secured obligation within ninety (90) days of the filing of the chapter 11 petition, and as it did not receive the certificate of deposit until six days after the letter of credit was issued.

LSC's analysis seems reasonable at first blush, particularly as there is no evidence of any urging by LSC for ACI to obtain the letter of credit to the disadvantage of other creditors, and for the further reason that LSC "gave up" pursuing its second writ of replevin in exchange for the letter of credit. However, LSC's analysis is lacking in some important respects.

First, although the transfer of the certificate of deposit (the debtor's property) was made to AMERICAN BANK it was clearly "for the benefit" of LSC because it indirectly secured payment of an undersecured antecedent debt owed by ACI. Secondly, it is not disputed that the promised transfer of the certificate of deposit to AMERICAN BANK induced the Bank to issue the letter of credit in favor of LSC. Consequently, by the so-called "contemporaneous transaction" there was a transfer of property of the debtor (ACI) for the benefit of the creditor (LSC).

b. *Creditor LSC Would Receive More Than in Chapter 7 Liquidation Proceeding.*

The next element the trustee must prove is that LSC would have received more from the letter of credit transaction than they would have received if the letter of credit transaction had not been made and LSC received distribution under a Chapter 7 proceeding. § 547(b)(5). The creditor asserts that there was no evidence before the Bankruptcy Court as to the value of the debtor's estate and therefore no such determination could have been properly made.

Upon a review of the transcript of October 24, 1985 it appears the

Bankruptcy Court conducted a hearing and elicited a narrowing of the issues and stipulations by the parties and reflects that the Bankruptcy schedules would be reviewed and relied on by the Bankruptcy Court to determine whether LSC was an undersecured creditor. The Bankruptcy Court in its opinion concluded the Bankrupt's total debts exceeded the total assets by approximately $50,000.[3] Thus, the Bankruptcy Court's finding that the letter of credit would have enabled LSC to recover more than they would under a Chapter 7 liquidation is supported by the record.

In summary, the Bankruptcy Court was correct in finding all the elements of a preferential transfer to LSC. There was clearly a transfer of property of the debtor for the benefit of a creditor when ACI obtained the letter of credit secured by the certificate of deposit which was timely delivered to AMERICAN BANK. Further, there is no question that the transfer of the certificate of deposit depleted the estate of the debtor. Since LSC was a vastly undersecured creditor prior to the date the ____ letter of credit secured by the certificate of deposit was issued, the letter of credit enabled it to receive more than it would have in a Chapter 7 proceeding at the expense of other creditors. Also, as conceded by LSC, the transfer of the certificate of deposit on June 21, 1984 was only one month before the bankruptcy petition was filed on July 25, 1984, well within the ninety day provision of § 547(b)(4). Additionally, the debtor ACI was concededly insolvent at the time of the transfer and, the transfer was made on account of antecedent debt.[4] Therefore, all the elements of a preference have been met.

Having properly found a preference the Bankruptcy Court then recited that the letter of credit was part of a "single contemporaneous transaction" and concluded that the appropriate remedy was to nullify the letter of credit issued by AMERICAN BANK. This is where the Bankruptcy Court erred.

Even though a letter of credit may be "contemporaneous" with other agreements between debtors and creditors, it still includes by its very nature and purpose an independent agreement between the customer and the Bank which is to be treated separately from the

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[3]It apparently is undisputed that the debtor's tangible personal property was subsequently sold by the trustee for only $1,000.00. Consequently, in light of the fact that ACI was indebted to LSC in an amount exceeding $47,000.000, the Bankruptcy Court's finding that LSC was undersecured has been borne out by the facts and cannot be said to be clearly erroneous.

[4]LSC also asserts that the transaction fits within the contemporaneous exchange exception of § 547(c)(1) because it allegedly gave new value when it agreed not to enforce the writ of replevin. However, simple forbearance from repossessing goods does not constitute new value. *Matter of Lario*, 36 B.R. 582 (Bankr.S.D.Ohio1983); *Matter of Duffy*, 3 B.R. 263 (Bankr.S.D.N.Y.1980).

agreement existing between the customer and the beneficiary. *In re Clothes, supra.*

In fact, the usefulness of a letter of credit as a recognized instrument in commerce rests on the premise that timely payment under the letter of credit will be forthcoming so long as the beneficiary complies with the terms and conditions of the letter of credit, regardless of any dispute between the account party and beneficiary or issuing bank. *East Girard Savings Assn. v. Citizens Nat'l Bank & Trust Co. of Baytown,* 593 F.2d 598 (5th Cir.1979). As was said in *Pringle-Assoc. Mortg. Corp. v. Southern Nat. Bank,* 571 F.2d 871, 874 (5th Cir.1978):

> The essence of a letter of credit is the promise by a bank, or other issuer, to pay money. The key to the uniqueness of a letter of credit and to its commercial vitality is that the promise by the issuer is independent of any underlying contracts.

The trustee, having established a preferential transfer to LSC, is not without a remedy even though the sanctity of the letter of credit is reaffirmed by this opinion. Section 550(a) provides that the trustee may recover either the debtor's property that was transferred or the value of such property from "the entity for whose benefit the transfer was made." In this case the property transferred was the certificate of deposit and the entity for whose benefit the transfer was made was LSC.

Since the creditor LSC received the benefit of a letter of credit as a preferential transfer, the trustee should be able to recapture from LSC the payment made pursuant to the letter of credit to the extent of the value of the certificate of deposit transferred to AMERICAN BANK without nullifying the letter of credit or the certificate of deposit itself. While this procedure may appear to be revering form over substance, as LSC will still "be out" the $20,000 under the facts of this case, LSC was at least assured that they would receive payment under the letter of credit. It is only the preference risk which may not be eliminated under the facts and circumstances of this case. Thus, this procedure only places the burden of repayment of the monies paid pursuant to the letter of credit where it belongs, upon LSC who received the preferential transfer to the detriment of other creditors of ACI, not upon AMERICAN BANK who issued the letter of credit.

A discussion of the sanctity of the letter of credit, particularly in Florida, would not be complete without an acknowledgment of *Matter of Twist Cap, Inc.*, 1 B.R. 284 (Bankr.M.D.Fla.1979). Although not referred to or mentioned by the Bankruptcy Court, it is relied on by the trustee as authority for affirming the Judgment appealed from.

In *Twist Cap,* a Bank issued three letters of credit for the account of the debtor Twist Cap in favor of two of Twist Cap's creditors. The issuance of the letters of credit took place more than four months before Twist

Cap filed a bankruptcy petition. The Bankruptcy Court issued a temporary restraining order prohibiting payment on the letters of credit in order to preserve the status quo pending a determination of the rights of the parties.

The beneficiaries of the letters of credit challenged the jurisdiction of the Bankruptcy Court to enjoin payment of the letter of credit as they were not properties of the debtor Twist Cap. The Bankruptcy Court rejected the beneficiary's argument and granted a preliminary injunction. The underlying basis for the Court's decision was the view that a letter of credit can constitute property of the bankrupt's estate and therefore is within the jurisdiction of the Bankruptcy Court.

The *Twist Cap* case did not invalidate or nullify the letter of credit as was done by the Bankruptcy Court in this case. Further, the *Twist Cap* decision has not been followed in subsequent decisions. *See, e.g., In re M.J. Sales & Distributing Co., Inc.*, 25 B.R. 608 (Bankr.S.D.N.Y.1982); *In re North Shore & Central Illinois Freight Co.*, 30 B.R. 377 (Bankr.N.D.Ill.1983); *Matter of St. Petersburg Hotel Associates, Ltd.*, 37 B.R. 380 (M.D.Fla.1984). Thus, *Twist Cap* is not determinative of this proceeding.

IV. CONCLUSION

After due consideration the Court concludes that that portion of the Bankruptcy Court's Opinion and Judgment finding a preference in favor of LSC is affirmed, and that portion of the opinion which nullifies the letter of credit, promissory note and assignment of certificate of deposit is reversed and this matter is remanded for further proceedings not inconsistent with this opinion.

In re AIR CONDITIONING, INC. OF STUART, Debtor(s).

AMERICAN BANK OF MARTIN COUNTY, Plaintiff,

v.

LEASING SERVICE CORPORATION, Defendant

Bankruptcy No. 84-01395-BKC-TCB
Adv. No.85-0965-BKC-TCB-A.

United States Bankruptcy Court, S.D. Florida.

Nov. 12, 1985.

MEMORANDUM DECISION

THOMAS C. BRITTON, Bankruptcy Judge.

The plaintiff bank has sued a creditor of the debtor asking this court to determine whether it owes $20,000 to the defendant/creditor or to the debtor's chapter 7 trustee. The creditor moved for abstention or dismissal. (C.P. No. 3). The trustee moved to intervene and tendered a complaint seeking recovery of the $20,000 upon the ground that it constituted a voidable preference under 11 U.S.C. § 547(b). (C.P. No. 6). The trustee has since abandoned a second count contained in the complaint. The matter was heard on September 17 and October 24.

At the first hearing this court agreed with the defendant/creditor that only the trustee has standing to maintain a preference action; however, since the trustee has intervened and asserted the preference claim, the creditor's motion to abstain or dismiss was denied.

Though not framed as such, the complaint is in effect an interpleader action under 28 U.S.C. §§ 1335, 1397, and 2361. B.R. 7022 incorporates Rule 22(1), *Fed.R.Civ.P. See Wright & Miller, Federal Practice and Procedure:* Civil, § 1701 ff. The $20,000 which is in dispute is held by the plaintiff bank in the form of a certificate of deposit drawing interest. Under these circumstances, plaintiff is excused from depositing the sum into this court's registry.

At the second hearing, the parties agreed that the essential facts appear from undisputed documents or are otherwise admitted and the parties stated their respective contentions. Further pleadings are, therefore, unnecessary. The parties have since submitted their arguments by memoranda.

The trustee claims that the following actions constituted a $20,000 preferential transfer of the debtor's property to or for the benefit of the creditor under 11 U.S.C. § 547(b).

On May 10, 1984 the creditor, Leasing Services, got a judgment against the debtor for $40,447 on account of an antecedent debt admittedly owing and past due. On April 24 and May 9 the creditor had obtained two writs of replevin on account of the same claim. The first was for the computer equipment leased to the debtor. The writ was executed before bankruptcy.

By stipulations dated June 11 and June 19 the parties agreed that the unexecuted second writ of replevin be replaced by a $20,000 letter of credit issued June 15, 1984 by the plaintiff bank.

The consideration for issuance of the letter of credit was the debtor's note dated June 15 in the amount of $20,000 which was secured by the assignment and delivery on June 21 to the bank of a $20,000 certificate of deposit owned by the debtor.

The debtor's bankruptcy petition was filed a month later on July 25. The sum still due the creditor was $37,067 with 18% interest as of November 6, 1984, after applying the proceeds ($5,000) from the execution of the first writ of replevin.

The creditor concedes three of the five elements specified in § 547(b), contesting only the first and fifth. The first element is that there was a:

> "transfer of property of the debtor (1) to or for the benefit of a creditor".

The creditor argues that it received only the letter of credit which was the bank's property, not the debtor's, and that there is no proof where the money came from to purchase the letter of credit.

I agree with the trustee that the letter of credit was but a part of a single contemporaneous transaction which included (a) the debtor's note to the bank (which bore the notation that its purpose was to establish the letter of credit) and (b) the assignment of the debtor's certificate of deposit. The assignment of the C.D. as security was an express condition stated on the note for the issuance of the letter of credit. By these documents both parties intended that $20,000 additional collateral for the antecedent debt be furnished to the creditor by the debtor through the bank as an intermediary. The transaction was concluded within seven days. This composite transaction was a transfer of the debtor's property for the creditor's benefit.

I also agree with the trustee that it is irrelevant where the money came from to purchase the C.D. The certificate was unquestionably property of the debtor and *it* was transferred by the debtor to the bank.

The creditor also argues that it would be against public policy to permit the nullification of a letter of credit under § 547. On the contrary, to permit a debtor and creditor to evade the preference statute by this

device would defeat the purpose of §547.

The trustee has proved the first element.

The fifth element requires proof that the transfer gave the creditor more than it would receive under a chapter 7 liquidation of this debtor's estate had the transfer not occurred.

This creditor had a duly perfected security interest in the debtor's: "goods, chattels, fixtures, furniture and equipment". (C.P. No. 30). This personal property was valued by the debtor at $21,711, but the inventory ($17,241) was subject to a $169,000 lien of another party and the remaining personalty ($4,470) was subject to purchase money liens of $4,250. All of the debtor's interest in its tangible personal property was sold by the trustee on February 21, 1985 for $1,000. (C.P. No. 57). The creditor is, therefore, grossly undersecured. The debtor's total debts exceeded its total assets by at least $50,000. Unsecured claims cannot be satisfied in full from this estate. I find, therefore, that the transfer at issue here gave the creditor far more than it would receive in liquidation. Of course, if I am mistaken this creditor will suffer no harm because this state is being liquidated now under chapter 7.

The creditor has also argued under § 547(c)(1) that the transfer was:

"a contemporaneous exchange for new value given to the debtor".

The new value claimed is the creditor's forbearance in executing its second writ of replevin of May 9, 1984. That writ was aimed at the same personal property just discussed which has been sold by the trustee for $1,000.

Forbearance is not "new value" as defined in § 547(a)(2). An obligation substituted for an existing obligation is expressly excluded from the definition of "new value". *Bavely v. Merchants National Bank (Matter of Lario)*, 36 B.R. 582, 584 (Bankr.S.D.Ohio 1983); *Matter of Duffy*, 3 B.R. 263, 266 (Bankr.S.D.N.Y.1980).

As required by B.R. 9021(a), a separate judgment will be entered avoiding under § 547 and, therefore, nullifying the debtor's note, the debtor's assignment of its certificate of deposit and the bank's letter of credit in favor of Leasing Services Corp. (each of which is in the amount of $20,000). The bank will be ordered to deliver the debtor's certificate of deposit to the trustee. The creditor may continue enforcement of its security interest as previously authorized by this court's order of October 4, 1984. (C.P. No. 30).

Upon its compliance with the foregoing requirements, the bank is discharged of further liability to Leasing Services and, except under the terms of the C.D., to the trustee.

Costs in the amount of $560 are assessed in favor of the plaintiff bank against the disputed fund. Therefore this amount may be setoff against the certificate of deposit. *Wright & Miller, supra* § 1719. Each party shall bear any other costs incurred by it.

In the Matter of COMPTON CORP.,
Debtor.
Walter KELLOGG, Trustee,
Plaintiffs-Appellant,
v.
BLUE QUAIL ENERGY, INC.,
Defendant-Appellee,
and
MBank Abilene, N.A., Appellee.
No. 87-1135.

United States Court of Appeals,
Fifth Circuit.
Nov. 12, 1987.
Rehearing Granted Jan. 12, 1988.*

Appeal from the United States District Court for the Northern District of Texas.

Before BROWN, JOHNSON and WILLIAMS, Circuit Judges.

JERRE S. WILLIAMS, Circuit Judge:

This is a bankruptcy preference case in which a bankruptcy trustee seeks to recover a transfer made via a letter of credit for the benefit of one of the debtor's unsecured creditors on the eve of bankruptcy. The bankruptcy court and the district court found there to be no voidable preference. We reverse.

I. *Factual Background*

In March 1982, Blue Quail Energy, Inc., delivered a shipment of oil to debtor Compton Corporation. Payment of $585,443.85 for this shipment of oil was due on or about April 20, 1982. Compton failed to make timely payment. Compton induced Abilene National Bank (now MBank-Abilene) to issue an irrevocable standby letter of credit in Blue Quail's favor on May 6, 1982. Under the terms of the letter of credit, payment of up to $585,443.85 was due Blue Quail if Compton failed to pay Blue Quail this amount by June 22, 1982. Compton paid MBank $1,463.61 to issue the letter of credit. MBank also received a promissory note payable on demand for $585,443.85. MBank did not need a security agreement to cover the letter of credit transaction because a prior 1980 security agreement between the bank and Compton had a future advances provision.[1] This 1980 security agreement had been perfected as to a variety of Compton's assets through the filing of several financing statements. The most recent financing statement

*Opinion on rehearing, 835 F.2d 584.

[1]A future advances clause in a security agreement subjects the specified collateral to any future loan made by the creditor in addition to the current loans.

had been filed a year before, May 7, 1981. The letter of credit on its face noted that it was for an antecedent debt due Blue Quail.

On May 7, 1982, the day after MBank issued the letter of credit in Blue Quail's favor, several of Compton's creditors filed an involuntary bankruptcy petition against Compton. On June 22, 1982, MBank paid Blue Quail $569,932.03 on the letter of credit after Compton failed to pay Blue Quail.

In the ensuing bankruptcy procceding, MBank's aggregate secured claims against Compton, including the letter of credit payment to Blue Quail, were paid in full from the liquidation of Compton's assets which served as the bank's collateral. Walter Kellogg, bankruptcy trustee for Compton, did not contest the validity of MBank's secured claim against Compton's assets for the amount drawn under the letter of credit by Blue Quail. Instead, on June 14, 1983, trustee Kellogg filed a complaint in the bankruptcy court against Blue Quail asserting that Blue Quail had received a preferential transfer under 11 U.S.C. § 547 through the letter of credit transaction. The trustee sought to recover $585,443.85 from Blue Quail pursuant to 11 U.S.C. § 550.

Blue Quail answered and filed a third party complaint against MBank. On June 16, 1986, Blue Quail filed a motion for summary judgment asserting that the trustee could not recover any preference from Blue Quail because Blue Quail had been paid from MBank's funds under the letter of credit and therefore had not received any of Compton's property. On August 27, 1986, the bankruptcy court granted Blue Quail's motion, agreeing that the payment under the letter of credit did not consitute a transfer of debtor Compton's property but rather was a transfer of the bank's property. The bankruptcy court entered judgment on the motion on September 10, 1986. Trustee Kellogg appealed this decision to the district court. On December 11, 1986, the district court affirmed the bankruptcy court ruling, holding that the trustee did not establish two necessary elements of a voidable transfer under 11 U.S.C. § 547. The district court agreed with Blue Quail and the bankruptcy court that the trustee could not establish that the funds transferred to Blue Quail were ever property of Compton. Furthermore, the district court held that the transfer of the increased security interest to MBank was a transfer of the debtor's property for the sole benefit of the bank and in no way benefitted Blue Quail. The district court therefore found no voidable preference as to Blue Quail. The trustee is appealing the decision to this Court.

II. *The Letter of Credit*

It is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate under 11 U.S.C. § 541. *In re W.L.*

Mead, Inc., 42 B.R. 57 (Bankr.N.D.Ohio, W.D.1984); *In re Leisure Dynamics, Inc.*, 33 B.R. 171 (Bankr.Minn.1983); *In re North Shore & Central Illinois Freight Co.*, 30 B.R. 377 (Bankr.N.D.Ill., E.D.1983); *In re M.J. Sales & Distributing Co.*, 25 B.R. 608 (Bankr.S.D.N.Y.1982). When the issuer honors a proper draft under a letter of credit, it does so from its own assets and not from the assets of its customer who caused the letter of credit to be issued. *In re W.L. Mead; In re M.J. Sales.* As a result, a bankruptcy trustee is not entitled to enjoin a post petition payment of funds under a letter of credit from the issuer to the beneficiary, because such a payment is not a transfer of debtor's property (a threshold requirement under 11 U.S.C. § 547(b). A case apparently holding otherwise, *In re Twist Cap., Inc.*, 1 B.R. 284 (Bankr.Fla.1979), has been roundly criticized and otherwise ignored by courts and commentators alike.

Recognizing these characteristics of a letter of credit in a bankruptcy case is necessary in order to maintain the independence principle, the cornerstone of letter of credit law. Under the independence principle, an issuer's obligation to the letter of credit's beneficiary is independent from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit. Any disputes between the beneficiary and the customer do not affect the issuer's obligation to the beneficiary to pay under the letter of credit.

Letters of credit are most commonly arranged by a party who benefits from the provision of goods or services. The party will request a bank to issue a letter of credit which names the provider of the goods or services as the beneficiary. Under a standby letter of credit, the bank becomes primarily liable to the beneficiary upon the default of the bank's customer to pay for the goods or services. The bank charges a fee to issue a letter of credit and to undertake this liability. The shifting of liability to the bank rather than to the services or goods provider is the main purpose of the letter of credit. After all, the bank is in a much better position to assess the risk of its customer's insolvency than is the service or goods provider. It should be noted, however, that it is the risk of the debtor's insolvency and not the risk of a preference attack that a bank assumes under a letter of credit transaction. Overall, the independence principle is necessary to insure "the certainty of payments for services or goods rendered regardless of any intervening misfortune which may befall the other contracting party." *In re North Shore*, 30 B.R. at 378.

The trustee in this case accepts this analysis and does not ask us to upset it. The trustee is not attempting to set aside the post petition

payments by MBank to Blue Quail under the letter of credit as a preference; nor does the trustee claim the letter of credit itself constitutes debtor's property. The trustee is instead challenging the earlier transfer in which Compton granted MBank an increased security interest in its assets to obtain the letter of credit for the benefit of Blue Quail. Collateral which has been pledged by a debtor as security for a letter of credit is property of the debtor's estate. *In re W.L. Mead*, 42 B.R. at 59. The trustee claims that the direct transfer to MBank of the increased security interest on May 6, 1982, also constituted an indirect transfer to Blue Quail which occurred one day prior to the filing of the involuntary bankruptcy petition and is voidable as a preference under 11 U.S.C. § 547. This assertion of a preferential transfer is evaluated in Parts III and IV of this opinion.

It is important to note that the irrevocable standby letter of credit in the case at bar was not arranged in connection with Blue Quail's initial decision to sell oil to Compton on credit. Compton arranged for the letter of credit after Blue Quail had shipped the oil and after Compton had defaulted in payment. The letter of credit in this case did not serve its usual function of backing up a contemporaneous credit decision,[2] but instead served as a back up payment guarantee on an extension of credit already in jeopardy. The letter of credit was issued to pay off an antecedent unsecured debt. This fact was clearly noted on the face of the letter of credit.[3] Blue Quail, the beneficiary of the letter of credit, did not give new value for the issuance of the letter of credit by MBank on May 6, 1982, or for the resulting increased security interest held by MBank. MBank, however, did give new value for the increased security interest it obtained in Compton's collateral: the bank issued the letter of credit.

When a debtor pledges its assets to secure a letter of credit, a transfer of debtor's property has occurred under the provisions of 11 U.S.C. § 547. By subjecting its assets to MBank's reimbursement claim in the event MBank had to pay on the letter of credit, Compton made a transfer of its property. The broad definition of "transfer" under 11 U.S.C. § 101(50) is clearly designed to cover such a transfer. Overall, the letter of credit itself and the payments thereunder may not be property of debtor, but the collateral pledged as a security interest for the letter of credit is.

Furthermore, in a secured letter of credit transaction, the transfer of debtor's property takes place at the time the letter of credit is issued (when the security interest is granted) and received by the beneficiary,

[2] As was the case in *In re W.L. Mead, Inc.*, *In re Leisure Dynamics*, *In re North Shore & Central Illinois Freight Co.*, and *In re M.J. Sales*, all *supra*.

[3] The letter of credit was dated May 6, 1982, and noted that it covered delivery of Oklahoma Sweet crude oil during March 1982.

not at the time the issuer pays on the letter of credit. *In re Briggs Transportation Co.*, 37 B.R. 76, 79 (Bankr.Minn.1984). *In re M.J. Sales, supra* (transfer of pledged collateral occurs not when bank forecloses on it, but when it is pledged.)

The transfer to MBank of the increased security interest was a direct transfer which occurred on May 6, 1982, when the bank issued the letter of credit. Under 11 U.S.C. § 547(e)(2)(A), however, such a transfer is deemed to have taken place for purposes of 11 U.S.C. § 547 at the time such transfer "takes effect" between the transferor and transferee if such transfer is perfected within 10 days. The phrase "takes effect" is undefined in the Bankruptcy Code, but under Uniform Commercial Code Article 9 law, a transfer of a security interest "takes effect" when the security interest attaches. Because of the future advances clause in MBank's 1980 security agreement with Compton, the attachment of the MBank's security interest relates back to May 9, 1980, the date the security agreement went into effect. The bottom line is that the direct transfer of the increased security interest to MBank is artifically deemed to have occurred at least by May 7, 1981, the date MBank filed its final financing statement, for purposes of a preference attack against the bank.[4] This date is well before the 90 day window of 11 U.S.C. § 547(b)(4)(A). This would protect the bank from a preference attack by the trustee even if the bank had not given new value at the time it received the increased security interest. MBank is therefore protected from a preference attack by the trustee for the increased security interest transfer under either of two theories: under 11 U.S.C. § 547(c)(1) because it gave new value and under the operation of the relation back provision of 11 U.S.C. § 547(e)(2)(A). The bank is also protected from any claims of reimbursement by Blue Quail because the bank received no voidable preference.

The relation back provision of 11 U.S.C. § 547(e)(2)(A), however, applies only to the direct transfer of the increased security interest to MBank. The indirect transfer to Blue Quail that allegedly resulted from the direct transfer to MBank occurred on May 6, 1982, the date of issuance of the letter of credit. The relation back principle of 11 U.S.C. § 547(e)(2)(A) does not apply to this indirect transfer to Blue Quail. Blue Quail was not a party to the security agreement between MBank and Compton. So it will not be able to utilize the relation back provision if it is deemed to have received an indirect transfer resulting from the direct transfer of the increased security interest to MBank. Blue

[4]Tex.Bus. & Com.Code Ann. § 9.312(g) specifies that for purposes of priority among competing secured parties, the security interest for a future advance has the same priorty as the security interest for the first advance. Conflicting security interests rank according to priority in time of filing or perfection. Tex.Bus. & Com.Code Ann. § 9.312(e)(1)

Quail, therefore, cannot assert either of the two defenses to a preference attack which MBank can claim. Blue Quail did not give new value under § 547(c)(1), and it received a transfer within 90 days of the filing of Compton's bankruptcy petition.[5]

III. *Direct/Indirect Transfer Doctrine*

The federal courts have long recognized that "[t]o constitute a preference, it is not necessary that the transfer be made directly to the creditor." *National Bank of Newport v. National Herkimer County Bank*, 225 U.S. 178, 184, 32 S.Ct. 663, 635¢G, 56 L.Ed. 1042¢G (1912). "If the bankrupt has made a transfer of his property, the *effect* of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it." *Id.* (Emphasis added). To combat such circuity, the courts have broken down certain transfers into two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party.

This is the situation presented in the case before us. The term "transfer" as used in the various bankruptcy statutes through the years has always been broad enough to cover such indirect transfers and to catch various circuitous arrangements. *Katz v. First National Bank of Glen Head*, 568 F.2d 964, 969 n. 4, (2nd Cir.), *cert, denied*, 434 U.S. 1069, 98 S.Ct. 1250¢G, 55 L.Ed.2d 771¢G (1978). The new Bankruptcy Code implicitly adopts this doctrine through its broad definition of "transfer."[6] Examining the case law that has developed since the *National Bank of Newport* case yields an understanding of what types of transfers the direct/indirect doctrine is meant to cover.

In *Palmer v. Radio Corporation of America*, 453 F.2d 1133 (5th Cir.1971), a third party purchased from the debtor a television station for $40,000 cash and the assumption of certain liabilities of the debtor, including unsecured claims by creditor RCA. This Court found the direct transfer from the debtor to the third party purchaser constituted an indirect preferential transfer to creditor RCA. We found that the assumption by the third party purchaser of the debt owed by the debtor to RCA and the subsequent payments made thereunder constituted a voidable transfer as to RCA. The court noted that such indirect transfers as this had long been held to constitute voidable preferences under bankruptcy laws. 458 F.2d at 1136.

[5]Nor does Blue Quail have the protection of the 11 U.S.C. § 547(c)(2) "ordinary course of business" preference exception. Getting a standby letter of credit issued to cover a debt several weeks past due does not constitute ordinary course of business.

Although the *Palmer* court did not elaborate its reasoning behind this holding, such reasoning is self evident. A secured creditor was essentially substituted for an unsecured creditor through the transfer of the television station to the third party purchaser and the assumption of the unsecured debt by the purchaser. The third party purchaser was in effect secured because it had the television station. Creditor RCA would receive payments directly from the solvent third party without having to worry about its original debtor's financial condition. The original debtor's other unsecured creditors were harmed because a valuable asset of the debtor, the television station, was removed from the debtor's estate. The end result of the *Palmer* case was that the third party's payments on the RCA debt were to be made to the debtor's estate instead of to RCA. RCA would then recover the same percentage of its unsecured claim from the estate as the other unsecured creditors.

In *In re Conrad Corp.*, 806 F.2d 610 (5th Cir.1986), we found a voidable indirect transfer on facts similar to those of *Palmer v. Radio Corporation of America.* In the *Conrad* case, the debtors bought several restaurants from the Burtons in exchange for an unsecured promissory note. A third party in turn purchased the restaurants from the debtors and assumed the payments to the Burtons on the promissory note. Relying on the analysis of the *Palmer* case, we held that the transfer of the restaurants by the debtors in exchange for a simultaneous assumption of the Burton debt by the third party benefitted the Burtons and constituted a voidable indirect transfer as to the Burtons.

We observed that as a result of executing the assumption of debt agreement, the debtors transfered to the Burtons the debtors' right to receive from the third party so much of the sales price for the restaurants as was needed to reimburse the Burtons on their unsecured note. Once again a secured creditor, in effect, was substituted for an unsecured creditor by the transfer, and a depletion of the debtor's estate occurred. We held that the trustee of the debtor could recover from the Burtons the payments made by the third party to the Burtons and that the Burtons' would recover only their proportionate share of the value of the unencumbered assets of the debtor along with the other unsecured creditors.

There are a number of federal cases in the other circuits supporting the holdings and reasoning in our direct/indirect doctrine cases. In *Aulick v. Largent,* 295 F.2d 41 (4th Cir.1961), a third party endorsed the debtor's antecedent obligation to one of the debtor's unsecured creditors in exchange for the transfer of some stock within the preference time period. The creditor eventually received payment from the third party who in turn retained the pledged stock. The Fourth Circuit held that while the direct transfer of the stock to the third party to

secure the contingent liability of the endorsement was not voidable because it was a transfer for consideration presently furnished, the indirect transfer to the unsecured creditor via the third party endorser was a voidable preference. The creditor in *Aulick* made the same argument that Blue Quail makes in the case at bar. The creditor claimed that the payment to it by the third party endorser came from the endorser's personal funds and thus the payment did not deplete the debtor's estate. Therefore one of the essential elements of a voidable preference was lacking.

The court rejected this argument relying on *National Bank of Newport*. The *Aulick* court found there to be two transfers arising from the pledge of stock to the third party, one direct and one indirect, and then collapsed them, in effect, into a single one for a preference attack against the indirect transferee creditor. The court noted that if the debtor had delivered the shares of stock directly to the unsecured creditor as security for the antecedent debt, the creditor would have clearly received a voidable preference. The court held that such a result could not be avoided by indirect arrangement.[7] "[P]references obtained by indirect or circuitous arrangements are to be struck down just as quickly as those obtained by direct arrangements."295 F.2d at 52.

In *Virginia National Bank v. Woodson*, 329 F.2d 836 (4th Cir.1964), the debtor had several overdrawn accounts with his bank.[8] The debtor talked his sister into paying off $8,000 of the overdrafts in exchange for an $8,000 promissory note and an assignment of some collateral as security. The debtor's sister made the $8,000 payment directly to the bank. The $8,000 technically was never part of the debtor's estate. The court, however, held that the payment of the $8,000 by the sister to the bank was a preference as to the bank to the extent of the value of the collateral held by the sister. The court noted that the measure of the value of a voidable preference is dimunition of the debtor's estate and not the value of the transfer to the creditor.

In the *Woodson* case the sister was secured only to the extent the pledged collateral had value; the remainder of her loan to her brother

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[7]Apparently the bottom line in the *Aulick* case was that the creditor and not the third party endorser was ultimately liable for the preferential transfer. This is the way the preference provisions are supposed to work; it was the creditor, after all, and not the endorser who was preferred. It should also be noted that there would have been no preference attack against the creditor had not the endorser received the assignment of stock from the debtor to secure its contingent liability on the endorsement. It is the substitution of a secured creditor for a general unsecured creditor that constitutes the voidable transfer as to the unsecured creditor. This is a common theme underlying the direct/indirect cases and applies with equal force to the case at bar.

[8]Unsecured antecedent debts.

was unsecured. Swapping one unsecured creditor for another unsecured creditor does not create any kind of preference. The court held that a preference in such a transaction arises only when a secured creditor is swapped for an unsecured creditor. Only then is the pool of assets available for distribution to the general unsecured creditors depleted because the secured creditor has priorty over the unsecured creditors. Furthermore, the court held that the bank and not the sister had received the voidable preference and had to pay back to the trustee an amount equal to the value of the collateral.

A slightly different indirect transfer was involved in *In re Mercon Industries, Inc.*, 87 B.R. 549 (Bankr.E.D.Penn.1984). In that case a debtor paid off a non-insider unsecured creditor within one year of the filing of the bankruptcy petition on a debt guaranteed by insiders of the debtor. The payment to the creditor had the effect of releasing the insider guarantors from contingent liability on the debt, thereby benefitting the insiders. The court held that releasing an insider guarantor from contingent liability is a beneficial transfer to the guarantor for purposes of 11 U.S.C. § 547.

The court in *Mercon* viewed the payment to the non-insider creditor as effecting two transfers under the Bankruptcy Code because of the secondary liability of the guarantors on the debt. The court held that while the direct transfer from the debtor to the non-insider creditor in satisfaction of the primary debt may not be a voidable preference (if it was made over 90 days of filing), the court found that the indirect transfer to the insider guarantors extinguishing their contingent liability (and their contingent unsecured claim for reimbursement) was a separate voidable transfer under 11 U.S.C. § 547. Such an indirect transfer is voidable if it occurred within one year of filing pursuant to § 547(b)(4)(B). Furthermore, the court held that because the Bankruptcy Code "dictates that there are two transfers rather than one, liability of the guarantors under § 547(b) need not be predicated on a finding of an avoidable transfer to [the non-insider creditor], since a finding of liability on one transfer is independent of the other, rather than derivative." 37 B.R. at 552. The court held that the insider guarantors, and not the non-insider creditor, were ultimately liable for this preference.[9]

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[9]*See also In re Deprizio Construction Co.*, 58 B.R. 478 (N.D.Ill.E.D.1986) (case with similar facts and a similar holding). This case also described the bankruptcy courts' equitable powers under 11 U.S.C. § 550 to preclude a trustee from recovering from innocent creditors who were the initial direct transferees of a voidable indirect preference.

IV. *The Direct/Indirect Doctrine in the Context of a Letter of Credit Transaction*

The case at bar differs from the cases discussed in Part III *supra* only by the presence of the letter of credit as the mechanism for paying off the unsecured creditor. Blue Quail's attempt to otherwise distinguish the case from the direct/indirect transfer cases does not withstand scrutiny.

In the letter of credit cases discussed in Part II *supra*, the letters of credit were issued contemporaneously with the initial extension of credit by the beneficiaries of the letters. In those cases the letters of credit effectively served as security devices for the benefit of the creditor beneficiaries and took the place of formal security interests. The courts in those cases properly found there had been no voidable tranfers, direct or indirect, in the letter of credit transactions involved. New value was given contemporaneously with the issuance of the letters of credit in the form of the extensions of credit by the beneficiaries of the letters. As a result, the 11 U.S.C. § 547(c)(1) preference exception was applicable.

The case at bar differs from these other letter of credit cases by one very important fact: the letter of credit in this case was issued to secure an antecedent unsecured debt due the beneficiary of the letter of credit. The unsecured creditor beneficiary gave no new value upon the issuance of the letter of credit. When the issuer paid off the letter of credit and foreclosed on the collateral securing the letter of credit, a preferential transfer had occurred. An unsecured creditor was paid in full and a secured creditor was substituted in its place.

The district court upheld the bankruptcy court in maintaining the validity of the letter of credit issued to cover the antecedent debt. The district court held that MBank, the issuer of the letter of credit, could pay off the letter of credit and foreclose on the collateral securing it. We are in full agreement. But we also look to the impact of the transaction as it affects the situation of Blue Quail in the bankrupt estate. We hold that the bankruptcy trustee can recover from Blue Quail, the beneficiary of the letter of credit, because Blue Quail received an indirect preference. This result preserves the sanctity of letter of credit and carries out the purposes of the Bankruptcy Code by avoiding a preferential transfer. MBank, the issuer of the letter of credit, being just the intermediary through which the preferential transfer was accomplished, completely falls out of the picture and is not involved in this particular legal proceeding.

MBank did not receive any preferential transfer — it gave new value for the security interest. Furthermore, because the direct and indirect

transfers are separate and independent, the trustee does not even need to challenge the direct transfer of the increased security interest to MBank, or seek any relief at all from MBank, in order to attack the indirect transfer and recover under 11 U.S.C. § 550 from the indirect transferee Blue Quail.

We hold that a creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction. The purpose of the letter of credit transaction in this case was to secure payment of an unsecured antecedent debt for the benefit of an unsecured creditor. This is the only proper way to look at such letters of credit in the bankruptcy context. The promised transfer of pledged collateral induced the bank to issue the letter of credit in favor of the creditor. The increased security interest held by the bank clearly benefitted the creditor because the bank would not have issued the letter of credit without this security. A secured creditor was substituted for an unsecured creditor to the detriment of the other unsecured creditors.

We also hold, therefore, that the trustee can recover under 11 U.S.C. § 550(a)(1) the value of the transferred property from "the entity for whose benefit such transfer was made." In the case at bar, this entity was the creditor beneficiary, not the issuer, of the letter of credit even though the issuer received the direct transfer from the debtor. The entire purpose of the direct/indirect doctrine is to look through the form of a transaction and determine which entity actually benefitted from the transfer.[10]

The fact that there was a prior security agreement between the issuing bank and the debtor containing the future advances clause does not alter this conclusion. As we pointed out in Part II *supra*, this prior security agreement gave MBank an additional shield from preferential attack because of the relation back mechanism of 11 U.S.C. § 547(e)(2)(A). 11 U.S.C. § 547(e)(2)(A), however, does not avail Blue Quail to shield it from a preferential attack for the indirect transfer. The indirect transfer to Blue Quail occured on May 6, 1982, when the letter of credit was issued and the increased security interest was pledged. This was the day before the involuntary bankruptcy petition was filed. For purposes of 11 U.S.C. § 547, a transfer of Compton's property for the benefit of Blue Quail did occur within 90 days of the bankruptcy filing.

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[10]We have found only one prior case that has fully addressed the application of the direct/indirect doctrine in the context of a letter of credit transaction. *In re Air Conditioning, Inc. of Stuart*, 55 B.R. 157 (Bankr.S.D.Fla.1985), *affirmed in part, reversed in part* 72 B.R. 657 (S.D.Fla.1987) (currently on appeal to the Eleventh Circuit). In a carefully and thoroughly reasoned opinion, the court reached the same conclusion we reach in this case.

The bankruptcy and district courts erred in failing to analyze properly the transfer of debtor's property that occurred when Compton pledged its assets to obtain the letter of credit. This transfer consisted of two aspects: the direct transfer to MBank which is not a voidable preference for various reasons and the indirect transfer to Blue Quail which is a voidable preference.

All of the requirements of 11 U.S.C. § 547(b) have been satisfied in the trustee's preferential attack against Blue Quail. There was (1) a transfer of Compton's property for the benefit of Blue Quail (2) for an antecedent debt owed by Compton (3) made while Compton was insolvent[11] (4) within 90 days before the date of the filing of the petition (5) that enabled Blue Quail to receive more than it would receive under a Chapter 7 liquidation.[12] The net effect of the indirect transfer to Blue Quail was to remove $585,443.85 from the pool of assets available to Compton's unsecured creditors and substitute in its place a secured claim for the same amount.

The precise holding in this case needs to be emphasized. We do not hold that payment under a letter of credit, or even a letter of credit itself, constitute preferential transfers under 11 U.S.C. § 547(b) or property of a debtor under 11 U.S.C. § 541. The holding of this case fully allows the letter of credit to function. We preserve its sanctity and the underlying independence doctrine. We do not, however, allow an unsecured creditor to avoid a preference attack by utilizing a letter of credit to secure payment of an antecedent debt. Otherwise the unsecured creditor would receive an indirect preferential transfer from the granting of the security for the letter of credit to the extent of the value of that security. Our holding does not affect the strength of or the proper use of letters of credit. When a letter of credit is issued contemporaneously with a new extension of credit, the creditor beneficiary will not be subject to a preferential attack under the direct/indirect doctrine elaborated in this case because the creditor will have given new value in exchange for the indirect benefit of the secured letter of credit. Only when a creditor receives a secured letter of credit to cover an unsecured antecedent debt will it be subject to a preferential attack under 11 U.S.C. § 547(b).

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[11]There is a presumption that a debtor is insolvent at least 90 days prior to its bankruptcy filing. 11 U.S.C. § 547(f).

[12]There was undisputed evidence below that the other unsecured creditors of Compton would receive less than fifty cents on the dollar for their unsecured claims.

V. *Liability of MBank for the Preferential Transfer*

Blue Quail has no valid claim against MBank for reimbursement for any amounts Blue Quail has to pay the trustee under the trustee's preference claim, just as the trustee has no preference challenge against MBank. Blue Quail received the preferential transfer, not MBank. MBank gave new value in exchange for the increased security interest in its favor. Thus, it is insulated from any assertion of a voidable preference. The bank in no way assumed the risk of a preference attack by issuing the letter of credit. For these reasons, we affirm the district court's dismissal of Blue Quail's request to proceed against MBank for reimbursement.[13]

In addition, the trustee may not set aside the $1,463.61 fee Compton paid MBank to issue the letter of credit. This payment is not a preferential transfer. MBank has fully performed its duties under the terms of the letter of credit and has earned this fee. The services MBank rendered in issuing and executing the letter of credit constitute new value under the 11 U.S.C. § 547(c)(1) preference exception.

VI. *Conclusion*

Blue Quail Energy received an indirect preferential transfer from Compton Corporation on May 6, 1982, one day prior to the filing of Compton's bankruptcy petition. We reverse the district court and render judgment in favor of Trustee Kellogg against Blue Quail Energy, Inc. in the amount of $585,443.85 plus interest to be fixed by the district court pursuant to 11 U.S.C. §§ 547, 550. The district court's dismissal of Blue Quail's claim against MBank for reimbursement is affirmed.

REVERSED IN PART, AFFIRMED IN PART, AND REMANDED.

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[13]The liability of MBank to Blue Quail in the event of this Court's finding a preferential transfer to Blue Quail is interrelated with the Trustee's preference challenge against Blue Quail. The briefs of Blue Quail and Trustee Kellogg both addressed this issue.

In the Matter of COMPTON CORPORATION,
Debtor.

Walter KELLOGG, Trustee,
Plaintiff-Appellant,

v.

BLUE QUAIL ENERGY, INC.,
Defendant-Appellee,

and

MBank Abilene, N.A., Appellee,

No. 87-1135.

United States Court of Appeals,
Fifth Circuit.

Jan. 12, 1988.

Rehearing Denied Feb. 29, 1988

ON PETITION FOR REHEARING

(Opinion November 12, 1987, 5th Cir.1987, 831 F.2d 586)

Before BROWN, JOHNSON and WILLIAMS, Circuit Judges.

PER CURIAM:

We grant the petition for rehearing for the narrow purpose of remanding one additional matter to the district court.

Our previous decision, *Matter of Compton Corp.*, 831 F.2d 586 (5th Cir.1987), remanded this case in order for the district court to determine the amount of interest due on the preference claim. We now hold that on remand the district court needs to make factual findings regarding the amount MBank actually foreclosed on and received from Compton Corp.'s trustee to cover the letter of credit transaction. In addition, the district court needs to determine the amount Blue Quail received from MBank under the letter of credit. The trustee states the amount paid to Blue Quail on June 22 , 1982, by MBank totaled $569,932.03, rather than $585,448.85, the face amount of the letter of credit and the amount Compton owed Blue Quail. This is a difference of $15,511.82. Whether this amount was paid to Blue Quail on another occasion by MBank under the letter of credit, whether Blue Quail and MBank reached some kind of compromise on the amount, or whether Blue Quail received this amount directly from Compton Corp. are all factual issues that need to be resolved by the district court on remand.

Overall, the amount of the preference which Blue Quail has to pay over to the trustee, prior to interest adjustments, is limited to the value of the collateral MBank actually foreclosed on to cover the letter

of credit transaction. This amount represents the dimunition of the assets in Compton's estate available to the unsecured creditors. This amount in turn is to be limited by the actual amount Blue Quail received from MBank under the letter of credit transaction.

REHEARING GRANTED.

ADDITIONAL REMAND TO DISTRICT COURT.